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Water Charge (Infrastructure) Rules 2010

Director
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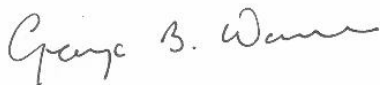
Dear Sir/Madam

Submission on the Proposed Water Charge (Infrastructure) Rules 2010

State Water welcomes the opportunity to comment on the Minister's proposed Water Charge (Infrastructure) Rules 2010. State Water's major issues of concern are detailed in the attached submission.

If you wish to discuss the State Water submission further please contact Joseph Caruana, regulatory analyst on 02 9354 1074, or joseph.caruana@statewater.com.au.

Yours sincerely



George Warne
Chief Executive Officer

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Scope of the Application of Water Charge Rules

State Water welcomes the *Water Amendment Regulations 2010 (No. 1)* which expands the definition of bulk water charges. State Water understands this will ensure the proposed water charge rules will cover all of State Water's customers (and indeed all users extracting water from NSW Rivers). State Water regards the legislative amendment as a positive step toward achieving the National Water Initiative of efficient functioning of water markets and the user pays principle.

However, as advised in previous submissions to the Australian Competition and Consumer Commission (ACCC), State Water is concerned with the limited coverage of the proposed water charge rules, both for bulk water charges and water resource planning and management (WPM) charges. The cost recovery of bulk water and WPM charges is applied unevenly across the Murray Darling Basin jurisdictions.

Currently the proposed rules will only apply in instances where water charges are already in place. SA Water and the Murray Darling Basin Authority (MDBA) are not captured by the water charge rules. State Water understands that the MDBA and SA Water are excluded on the basis that they do not have a separate water charge and therefore technically fall outside the remit of the water charge rules under the *Water Act 2007*. Clearly this undermines the objective of taking a whole-of-Basin approach.

This limitation will reduce the ability of the rules to meet their legislative objectives of transparency and consistency in order to promote the efficient use of resources and facilitate the efficient functioning of water markets. It will also disadvantage those jurisdictions which are already compliant with the National Water Initiative charging principles.

The NSW Government currently recovers its contribution to the MDBA bulk water and WPM costs via the pricing determinations for State Water and the NSW Office of Water. Although this approach results in MDBA costs being recovered from users, it is not ideal. The MDBA is not subject to the same independent and transparent scrutiny of costs as State Water and the NSW Office of Water. Therefore, as an unregulated monopoly, there is limited incentive for the MDBA to drive efficiency improvements.

State Water urges the Minister to amend the *Water Act 2007* to mandate all operators be subject to the water charge rules.

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Determination of external (Government) contributions

State Water questions the adjustment to proposed rule 29(2)(b), outlined as follows in the summary advice of the Department of Environment, Water, Heritage and the Arts:

It is expected that government and other contributions will be decided before and outside of the Part 6 price approval/determination process and determined by Government policy.¹

State Water understands the intention of the regulator is to avoid involving itself in determining government policy by refusing to articulate government contributions to state owned corporations. However, proposed rule 29(2)(b) does not take into account the operation of cost share ratios between the NSW Government (as a customer) and end users, as well as NSW Government subsidies to customers in valleys where charges are set below full cost reflective levels (such as occurs for customers in the Peel, North Coast and South Coast valleys).

The Independent Pricing and Regulatory Tribunal (IPART), in determining State Water's regulated charges for the 2001, 2006 and 2010 regulatory periods, recognised that not all costs borne by end users can be wholly attributed to their demand for water. IPART allocated costs related to past decisions ('legacy costs') fully to Government, and allocated current and future costs to users using an 'impactor pays' approach.

The cost share ratios (between Government and customers) were established by IPART in State Water's 2001 determination. The cost share ratios were subsequently reviewed for the 2006 determination by the Centre for International Economics (CIE), who concluded the cost share arrangements in place were appropriate. IPART adopted these cost share ratios for State Water's 2010 determination².

Further, external funding arrangements for bulk water infrastructure operators specific to each jurisdiction will reinforce current inconsistencies across the Murray Darling Basin and hinder the efficient functioning of water markets. This will result in barriers to trade between States and disadvantage jurisdictions who have proactively adopted user pays water pricing. Such an arrangement is equivalent to allowing individual jurisdictions to determine diverse distribution subsidies in the national electricity market.

¹ Department of Environment, Water, Heritage and the Arts, *Water Infrastructure Charge Rules under section 92 (1) of the Water Act 2007, Public Consultation*, p. 5.

² IPART's decision on percentage user cost share of operating and capital expenditure is set out in Table 8.1 on page 108 of the *Final Report - Review of Bulk Water charges for State Water Corporation - From 1 July 2010 to 30 June 2014 - June 2010*

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In practice, it is likely the NSW Government will seek an independent regulator to calculate these cost share ratios under the proposed rules. This will require State Water to undergo two separate regulatory processes with different regulators for each determination period. This will increase business compliance costs.

In addition, in regard to its practical application, as proposed rule 29(2)(b) currently stands, the cost share ratios must be determined without knowing what State Water's total efficient revenue requirement will be. This mandates that the NSW Government commits to funding a proportion of State Water's revenue requirement without knowing the quantum of funding required.

Proposed rule 29(2)(b) is also problematic for determining NSW Government subsidies in valleys where charges are set below full cost reflective levels. The NSW government may decide, for social or economic reasons, to provide a subsidy for valleys at less than full cost recovery. However, the NSW Government will need to make funding decisions on such subsidies without the prior knowledge of the level of regulated charges in each valley.

State Water's believes the regulator should determine the total efficient revenue requirement, in order to achieve the National Water Initiative objectives and to avoid government funding allocations being made on asymmetric information. For the same reasons, State Water also believes that the rules should provide for cost shares to be determined by the regulator on a consistent basis across the Basin.

Regulatory Asset Base

Schedule 2 of the proposed Water Charge (Infrastructure) Rules prescribes that the Regulatory Asset Base (RAB) for the initial period be based on the closing value used by the jurisdictional regulator for the preceding period.³ State Water believes that changes in regulatory approach on Weighted Average Cost of Capital (WACC) should not be made in isolation of the opening RAB value.

In IPART's 2006 Determination for State Water, IPART moved from an annuity to RAB based approach, arguing that the RAB approach was superior in terms of economic efficiency and regulatory effectiveness.⁴ In determining an opening RAB value, IPART capitalised the previously determined annuity charge using a discount rate of 7.0 per cent, to provide an equivalent capital return under the RAB approach. The 7.0 per cent discount rate was predicated on IPART's real pre-tax WACC framework, based on a statutory tax rate of 30 per cent, gamma of 0.4 and equity beta of 0.9.

³ For those operators whose fees and charges were determined by an agency of the State under a law of the State.

⁴ Independent Pricing and Regulatory Tribunal, *Bulk Water Prices for State Water Corporation and Water Administration Ministerial Corporation, From 1 October 2006 to 30 June 2010*, September 2006.

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Under the post-tax approach advocated in the ACCC's Draft Pricing Principles,⁵ State Water faces a significant reduction in WACC due to the proposed:

- post tax WACC formulation, which effectively translates to a zero tax rate for State Water,
- increase in gamma from 0.4 to 0.65, and
- reduction in equity beta from 0.9 to 0.7.

Had IPART applied the equivalent WACC parameters in determining State Water's opening RAB, the discount rate used to capitalise the annuity charge would have been 5.7 per cent rather than 7.0 per cent. This would have led to a material increase in State Water's opening RAB valuation at the time of its corporatisation.

Under the Draft Pricing Principles, State Water is potentially exposed to a lower WACC on a RAB valued at substantially below replacement cost.⁶ Given that IPART already acknowledges that State Water's credit rating is expected to fall below investment grade over the 2010 determination period, State Water can ill afford further reductions in regulated returns.⁷

State Water believes that bulk water operators should not be penalised over the transition from a state based to national based regulatory framework. Given the inherent circularity between the opening RAB value and WACC, State Water strongly believes that if the changes to the WACC framework are pursued under the Draft Pricing Principles, that the opening RAB under the Water Charge (Infrastructure) Rules be adjusted to keep the return on capital constant.

State Water acknowledges that the Pricing Principles, including WACC parameters, are still draft and subject to future consultation. However, given that the Pricing Principles will not be finalised until after the Water Charge (Infrastructure) Rules is legislated, State Water proposes that guidelines relating to the determination of opening RAB values should be removed from the Water Charge (Infrastructure) Rules and included in the Pricing Principles, to ensure that decisions on WACC are not made in isolation of opening RAB values. Alternatively, should the determination of opening RAB values remain within the Water Charge (Infrastructure) Rules, these Rules and any associated guidelines should provide flexibility for these impacts to be ameliorated.

⁵ Australian Competition and Consumer Commission, *ACCC pricing principles for price approvals or determinations under the water charge (infrastructure) rules*, Draft, July 2010.

⁶ The opening RAB valuation determined in IPART's 2006 Determination represented an approximate \$2.25 billion (90 per cent) discount to replacement value.

⁷ Independent Pricing and Regulatory Tribunal, *Review of bulk water charges for State Water Corporation*, From 1 July 2010 to 30 June 2014, Water - Final report, June 2010, Page 25.

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Opening a Determination mid term

State Water is generally supportive of the Regulator varying an approval or determination to reflect extenuating circumstances (proposed Rule 40). However, State Water questions why the mid term review trigger is restricted to events that cause an operator's total expenditure to exceed 5 per cent of the value of its regulatory asset base. The use of an individual operator's RAB causes the threshold to increase significantly over time for operators with increasing asset bases, compared to those who have steady or declining asset bases.

Under State Water's 2010 IPART determination, the 5 per cent threshold equates to \$23.3 million in 2010-11.⁸ Hence, State Water would be required to manage an additional cost \$23.3 million (25 per cent of its total regulated expenditure⁹) before being able to apply to the regulator to vary the determination. The \$23.3 million threshold is of particular concern in relation to operating expenditure because it has less potential to be deferred than capital expenditure.

State Water believes the threshold trigger be aligned to the annual regulated revenue requirement rather than the RAB.

While the rule refers to total expenditure, Rule 40 (2)(c)(iii), refers only to additional capital expenditure. This appears to be an oversight. If indeed the intention is to restrict application of the proposed rule to increases in capital expenditure, State Water believes it should be amended to provide also for increases in operating expenditure.

Accreditation of State agencies

State Water notes the changes to rule 59(1)(c) to clarify the circumstances in which the ACCC can impose terms, conditions or obligations on accreditation of state agencies. However, the rules do not outline a process for altering such accreditation principles should the need arise. This could potentially lead to the ACCC altering the accreditation principles without undertaking a consultation process with affected stakeholders. State Water believes such consultation should be provided for, to avoid regulatory uncertainty.

⁸ State Water's 2010-11 opening RAB is \$466.357 million. Ibid, Table 7.5 Annual review for State Water's RAB for the 2010 Determination, p.104.

⁹ The IPART-determined 2010-11 total regulated revenue requirement is \$94.096 million). Ibid, Table 7.7, IPART decision on total notional revenue requirement, p.105.